2001 REPORT:

CREDIT UNIONS AND THE FLORIDA SECURITY FOR PUBLIC DEPOSITS ACT

COMMITTEE ON BANKING

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Executive Summary

A Qualified Public Depository (QPD) is a bank or savings and loan association authorized to do business in Florida that is qualified by the Treasurer to receive public funds. The QPD Act has been operational since 1982, and the Act requires the financial institutions to enter into guarantee pool agreements (otherwise known as "cross-collateralization") that reduce the cost of collateralization and still offer protections against the loss of public funds in the event of a bank failure.

Since at least 1996, credit unions have lobbied for QPD status in Florida, despite the fact that the National Credit Union Administration (NCUA), the federal regulator for credit unions, does not allow credit unions to cross-collateralize. According to proponents of the concept, allowing credit unions to participate in the QPD program would likely inure benefit to the state and other public units because the credit union's tax-exempt status would allow the credit unions to offer higher returns on deposits than the banks and savings and loans. Representatives of the larger, national banks, which currently hold over 75 percent of Florida public deposits, state no position on the issue. The state-chartered, community bankers, however, question whether the inclusion is necessary and they oppose the inclusion of the credit unions because the market is not underserved.

Florida's Comptroller and Treasurer have no official position on the issue but both rely upon the diligence of their respective agencies' personnel to monitor the viability of the financial services industry and administer the public fund depository program. The Department of Banking and Finance, concerned squarely with safety and soundness of state-chartered financial institutions, suggests that inclusion should not impact the safety and soundness of those institutions under the assumption that asset deployment (loans/securities) is handled in satisfactory manner.

To become qualified under the program, however, depository institutions must meet certain criteria established by the State Treasurer's Office that confirm satisfactory operations. In 1996, the credit unions approached the state seeking QPD status. The Division of Treasury, which administers the QPD program, delivered to the credit unions a series of preliminary, technical questions relating to the interest in the industry to participate in the program.

- What would be minimum number of participants?
- Would there be enough interest from the credit union industry to appoint representatives to an oversight board?
- What would be the credit union equivalent of the "Call Report" or "Thrift Financial Report"?

- What are nationally recognized financial rating services for credit unions?
- What type of institutions would credit unions use as custodians?
- Would public units be allowed to use credit union that is affiliated with the public unit?
- What are the claim procedures for NCUSIF?
- What actions are planned regarding local government laws and investment policies?

So far, a total of 43 federal and state credit unions have expressed interest in the program. The QPD administrators are still seeking answers to the remaining questions.

The impediments that kept the credit unions from participating in the Florida QPD program in 1996, still exist today, the greatest of which is the federal regulator that prohibits credit unions from participating in Florida's program. Public policy decisions include: (1) keeping the status quo until such time as the federal regulator changes its position regarding cross-collateralization; (2) amend the law to include credit unions in the QPD program in anticipation of a change of NCUL policy; or (3) eliminate the cross collateralization system in favor of another cost-effective system that will permit all financial institutions to participate without loss of protection to public funds.

Introduction

The Florida Security for Public Deposits Act (Chapter 280, F.S.) protects time deposits and checking accounts of public depositors (the state, any county, school district, community college district, special district, metropolitan government, municipality, or court) in the event of a default or insolvency of a bank or savings association that operates as a public depository. During the 2001 Regular Session, at the April 4, 2001, Banking Committee meeting, Representative Brutus inquired as to the impact of authorizing credit unions to participate in the Qualified Public Depository (QPD) program at the state level. Several questions were raised during the meeting, prompting Chairman Flanagan to propose that during the interim committee staff research answers to the questions regarding these issues. Speaker Feeney approved this proposal as an interim project. The questions raised were:

- Will the change impact the safety and soundness of credit unions and impact the National Credit Union Share Insurance Fund (NCUSIF) (which is the deposit insurance fund for all federally insured credit unions)?
- Will the change negatively impact other depository institutions such as banks and savings associations?
- Will the change benefit the State of Florida, local governments, and the citizens/credit union membership of the State of Florida?
- Is there sufficient credit union industry support or need to justify the Chapter 280 changes? and,
- Will the change improve competitive equality with federally chartered credit unions?

To address these questions, staff researched the available electronic databases provided by the federal and state government regarding the financial services industry regulation and the QPD program, and discussed the various issues with state and federal regulators as well as industry representatives from the state credit union and banking associations. The Division of Treasury, the state regulator administering the QPD program, posed technical questions to the credit unions when, in 1996, they approached the state regarding participation in the program. The first question, regarding the actual number of institutions that wanted to participate in the program, was answered recently by the Florida Credit Union League (FCUL), which received responses to an internal survey sent to its 250 + members. Of the 71 that responded a total of 43 credit unions indicated that they would be interested in receiving public funds under the program. The remaining questions are as follows:

- Would there be enough interest from the credit union industry to appoint representatives to an oversight board?

- What would be the credit union equivalent of the "Call Report" or "Thrift Financial Report"?
- What are nationally recognized financial rating services for credit unions?
- What type of institutions would credit unions use as custodians?
- Would public units be allowed to use credit union that is affiliated with the public unit?
- What are the claim procedures for NCUSIF?
- What actions are planned regarding local government laws and investment policies?

This report will provide a brief history of the QPD program, outline the present situation against the backdrop of state and federal law, and then address these questions in turn.

The Deposit of Public Monies Prior to the QPD Program

Before the implementation of the QPD Program in Florida in 1982, there was no uniform standard for the deposit and collateralization of public monies. Individual public treasurers and fund custodians operated in isolation and, as a result, governmental units maintained separate collateralization programs with disparate practices and requirements. The Treasurer handled the collateral for only state funds, but every county, school district, community college district, special taxing district, metropolitan government, municipality, court, agency, board, bureau and commission also had a program. Every public unit was required to contact financial institutions and individually negotiate collateral requirements for depositing its public monies. This lack of uniform practice often resulted in inefficiencies and high costs for both the governmental units and the depositories. For example, a bank that accepted public deposits from 10 separate governmental units operated under 10 separate agreements with 10 different sets of criteria and collateral requirements. Every public unit employee and bank employee was required to have working knowledge of market value information for the securities pledged. Every deposit, which could occur daily if one had several public units as customers, required a separate agreement with a security receipt. This system was time consuming and cumbersome for the public unit and especially the bank, for the reasons noted above.

Collateral was directly tied to specific deposits and the pledgor bank was usually required to provide collateral that had a market value of 100 percent or higher than the deposit. In the event that collateral needed to be shifted by the bank, the public unit required subsequent collateral substitution agreements with releases. In time, a group of bankers approached the Comptroller and Treasurer and requested assistance in devising a uniform standard for the deposit of public funds, which culminated in Chapter 280, F.S.

State Regulation and Oversight of the QPD Program

Florida's Constitution (Article IV, Section 3) charges the State's Treasurer with keeping all State funds and securities and dispersing these funds upon the order of the Comptroller. In addition, Section 18.10, F.S., requires the Treasurer to deposit Treasury funds in "qualified public depositories" that offer collateral security for the funds deposited. The Florida Security for Public Deposits Act (Ch. 280, F.S.) empowers the Treasurer to administer the QPD Program that protects time deposits and checking accounts of governmental entities (public depositors) in the event of a default or insolvency of a bank or savings association that operates as a public depository.

To qualify as a qualified public depository, a bank or savings association must provide specific information to the Department of Insurance describing the assets of the institution. A qualified public depository is also required to collateralize a specified portion of the public monies on deposit so that the public deposits are available immediately should the need arise. In addition, a financial institution must have procedures and practices for identification, classification, reporting and collateralization of public deposits.

The Act sets forth percentages of public funds that a qualified public depository must collateralize. That amount varies depending upon the assets of the institution and other factors. The pledging levels that qualified public depositories must meet and the collateral requirements are set forth in the Act and Rules 4C-2.006 and 4C-2.024, Florida Administrative Code.

Supervising and Administering Collateral

According to information provided by the Government Finance Officers Association (GFOA)[1], there are basically three methods of supervising and administering collateral:

- Statutory permission to implement depository collateralization on a voluntary basis. Local officials bear complete responsibility for their collateralization practices. This model usually results in higher costs of obtaining collateral due to the lack in uniform practices.
- General statewide requirements for full collateralization as a condition for doing business with public entities. This model requires uniform statewide collateralization of all public deposits, but may leave the responsibility for enforcement and implementation to local or state officials. Like the first model, the forms of collateral

[1] The GFOA is a professional association of state/provincial and local finance officers dedicated to the sound management of government financial resources. The information above was gleaned from An Introduction to Collateralizing Public Deposits for State and Local Governments, by M. Corrine Larson, dated October 1996.

and other mechanical details of the practice vary.

- Creation of a statewide collateral pool by legislative action, with a central agency supervising a system of partial collateralization.

Florida has utilized cross collateralization since 1982.[2] Banks and savings and loan associations enter into combined guarantee pool agreements that reduce the cost of collateralization and still offer protections against the loss of public funds in the event of a bank failure. This is sometimes referred to as "cross collateralization" because each QPD essentially cross-collateralizes or guarantees the deposits for all other QPDs. The likelihood of loss to other pool members is limited due to the collateralization requirements of the program. Collateralization requirements, which start at 25 percent for strong, well-run institutions, increase on a scale up to 200% of the existing deposits if there are declines in the financial condition of each individual public depository. QPDs can be removed from the approved list if a certain degree of financial decline exists. The Advisory Board for the Public Deposits program, which is made up of industry representatives, is responsible for taking these types of actions.

According to the annual report of the Treasurer, as of June 30,1999, there were 205 qualified public depositories. The total average daily balance of public deposits for June 1999, was approximately $4.5 billion.

For comparison purposes, for the month ending June 30, 2001, there were 199 qualified public depositories, with total public deposits running over $5.8 billion. Federal, or federally insured national banks and trust companies currently hold over 78 percent of public deposits.

Federal Regulation of Credit Unions

In many ways credit unions bear a resemblance to banks. Both institutions offer a variety of financial services, from savings and checking accounts to loans for cars, homes, and businesses. The differences between the two, however, lie in the roots of their origins, their internal organization, membership, and in their regulation.

From their early origins in 19th century Europe, credit unions were unique depository institutions created, not for profit, but to serve members as credit cooperatives. Unlike the for-profit banks, credit unions were democratically governed where each member was entitled to one vote, and the volunteer board of directors was member-elected. In short, a credit union is owned and run by its members. Credit unions grew in popularity in the early 1920's as a

[2] Florida Statute section 280.07 -- Mutual Responsibility -- acts like a guaranty clause for all public depositories; if there is a bank failure all public depositories must shoulder a pro-rata share of the public deposits lost.

source of inexpensive credit because banks were not generally interested in providing consumer credit.

In 1934, President Roosevelt signed the Federal Credit Union Act into law, authorizing the establishment of federally chartered credit unions in all states. The purpose of the federal law was "to make more available to people of small means credit for provident purposes through a national system of cooperative credit..." [3] Unlike banks, which may offer services to anyone, credit union membership is limited to groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district.[4] In addition, credit unions are exempted from paying federal income tax, which helps these institutions to compete with banks for consumer accounts by offering reduced fees for services and often a better rate of return for investments.

In 1970, the National Credit Union Administration (NCUA) was created to charter and supervise federal credit unions and the National Credit Union Share Insurance Fund (NCUSIF) was organized to insure credit union deposits. Like the Federal Deposit Insurance Corporation (FDIC), which regulates and insures banks' deposits, the NCUA insures credit union deposit accounts up to $100,000.

[3] 12 U.S.C. § 1751
[4] 12 U.S.C. § 1759

Credit Unions and Public Deposits

The Federal Credit Union Act authorizes federal credit unions and federally insured credit unions to be depositories of public money.[5] The NCUA, however, does not allow federally insured credit unions to guarantee, or cross collateralize, public deposits in other credit unions. In a legal opinion dated May 2, 1996, Richard S. Schulman, Associate General Counsel for the NCUA writes:

> *Serious safety and soundness issues would also be raised by the practice, if permitted. Your representations that: (1) only credit unions would form the guarantor group for Florida public funds held in Florida FCUs; (2) no losses have yet occurred in bank and thrift guaranty pools of Florida public funds; (3) the Federal Deposit Insurance Corporation ("FDIC") insures such accounts held at FDIC-insured banks and thrifts; and (4) credit unions are placed in a competitive disadvantage by not having such authority; are not germane to the issue of the permissibility of the activity. As you know, FCUs are unique financial*

[5] 12 U.S.C. 1767, 1789a. Federal credit unions may receive payments, representing equity on shares, share certificates and share draft accounts from nonmember units of federal, state, local or tribal governments and political subdivisions as enumerated in section 207(k)(2)(A) of the Act. 12 U.S.C. 1757(6).

institutions that do not have all the powers granted to FDIC insured banks and thrifts. Nor is competitive inequality alone sufficient to justify the creation of an incidental power. The agency's response to your inquiry must remain the same as it has been in the past.[6]

Cross collateralization is a requirement by the State Treasurer under the existing bank/savings and loan public depository program. In the event of failure of a credit union QPD there exists the possibility of increased losses to the NCUA, due to the potential dissipation of assets inherent in the pledging requirements of the program, which would increase the liquidation cost of the failure. NCUA's cross collateralization prohibition notwithstanding, the Division of Treasury, Bureau of Collateral Securities, provided a cursory list of questions to the credit union industry to determine the ability of the industry to participate in the program, listed below.

Credit Union Participation in the Florida Program

Historically, state regulators have not stated any general opposition to the idea of including credit unions in the QPD Program. In fact, some regulators have opined that as long as the group adheres to current regulations for financial soundness and asset collateralization, inclusion would likely lead to more competition among depository institutions and possibly result in more advantageous interest rates for public units. However, the regulator's full acceptance of allowing credit unions to be part of the program still hinges on the answers to certain technical questions that were posed to industry representatives. The same questions, reiterated below, were re-delivered by Banking Committee staff to the credit union representatives.

Q. What would be minimum number of participants?

A. Although a safe "minimum" number of participants has never been discussed, this question strives to determine the number of credit unions that may want to participate in the pool. Logically, the larger the number the greater the spread of risk and the lesser chance of a "domino effect" if a failure were to occur. The Florida Credit Union League sent out a survey to it's 250 + federal and federally chartered credit union members in the state. Of the 71 that responded a total of 43 credit unions indicated that they would be interested in receiving public funds under the program while 27 were not interested, or undecided.

According to the FCUL-generated table, the size of the interested institutions varies greatly, from one with $434,000 and a Loan to Shares ratio of zero percent, to one with over $2 Billion with a Loan to Shares ratio of 80 percent. While 10 separate institutions have Loan to shares ratios at 90 percent or higher,

[6] This opinion letter is accessible at http://www.ncua.gov/ref/opinion_letters/96-0410.html

three of these have ratios over 100 percent. According to the Division of Treasury, the report indicates that most credit unions have a very high loan to share/deposits ratio, and although making loans to customers is the primary business of a credit union, loans should never exceed assets. The Division of Treasury raised two additional concerns: (1) With credit unions being so loaned up, it would have to be understood up front that "Loans" would not be an acceptable collateral type; and (2) Southeast Corporate is, in best knowledge, a credit unions credit union. Southeast answered "yes" to the question "Is your CU interested". Under the current public deposits program a bankers bank is not eligible to act as a qualified public depository and accept Florida public deposits, therefore, a credit unions credit union would not be eligible to accept Florida public deposits. This serves to indicate just how answers to these questions raise more questions to determine whether credit unions could, technically, operate as a QPD in their present state.

Q. Would there be enough interest from the credit union industry to appoint representatives to an oversight board?

A. The Bank Oversight Board is comprised of 6 members, chosen by financial institutions with the most public deposits in three categories (less than $100 mm, $1 to $3 mm, and over $300mm). The Board helps decide the level of administration the financial institutions want from the state (a balance of regulation over risk).

Q. What would be the credit union equivalent of the "Call Report" or "Thrift Financial Report"?

A. Call Reports are also known as “Quarterlies” and the ranking for collateral pledge levels depends upon the strength of the bank, based upon its reports as interpreted by the national financial rating services, Sheshunoff Information Services, and IDC Financial Publishing, Inc.

Q. What are nationally recognized financial rating services for credit unions?

A. The nationally recognized financial rating services for banks and savings and loan associations, Seshunoff and IDC, examine every financial institution’s quarterly report and assign a number rank to the institution, based upon its relative financial strength or weakness. The State Treasurer utilizes these rankings to assign collateral pledge levels to each QPD (25, 50, 125, and 200 percent) in the program. As of June 2001, there were 34 institutions with a 25 percent pledge level, 120 institutions with a pledge level of 50 percent, 43 institutions with a pledge level of 125 percent, and one institution with a pledge level of 200 percent.

Q. What type of institutions would credit unions use as custodians?

A. The financial strength of the custodial bank is key, so the program administrators would need to know which institutions the credit unions would use to “hold” their collateral.

Q. Would public units be allowed to use a credit union that is affiliated with the public unit?

A. Because political subdivisions have associated credit unions (i.e., FAMU Credit Union, FSU Credit Union, Tallahassee Credit Union), there may be a “sharing” of director’s/administrators which raises concerns about the “arms length” dealing between the financial institution and the public unit providing funds.

Q. What are the claim procedures for the National Credit Union Share Insurance Fund (NCUSIF)?

A. The credit unions’ federal insurer (akin to the banks’ FDIC) the National Credit Union Share Insurance Fund (NCUSIF) is the federal fund created by Congress in 1970, to insure member's deposits in credit unions up to the $100,000 federal limit. The claims procedures for the NCUSIF in the event of a failure is crucial, as the FDIC claims absolute authority in the determination of what is insured and what is not under the program.

Q. What actions are planned regarding local government laws and investment policies?

A. This issue addresses the myriad changes to Florida Statutes that may need to be made in light of the various political subdivisions and their individual investment strategies such a change will affect.

Q. What is the liability for shareholders in the event of a failure?

A. An issue that surfaced during more recent discussions on the subject that was not reflected in the previous technical issues concerned the potential liability for shareholders (members) of credit unions for losses in the event of a failure.

According to the administrators for the QPD program, when these issues are addressed by the credit unions, it is conceivable that their answers will generate more questions by the Treasurer.

Answers to the Banking Committee Questions

The following questions were delivered to the Department of Banking and Finance, the representatives for the state community bankers, and the credit union representatives.

Generally speaking, the community bankers oppose the inclusion of the credit unions in the program on the grounds that (1) this market is not underserved, and (2) the federal regulator prohibits credit unions from participating in the collateral “pool.” The bankers raise another concern that any changes to the existing program to allow participation outside of the collateral pool may provide less security for public funds. Due to the fact that federal institutions hold over 75 percent of public deposits (figures for June, 2001), the community bankers compete among themselves for the remainder of the total public deposit "pie." Given the credit union's tax-exempt status they may be able to offer better terms to the public units and community bankers feel they will be the institutions that will be losing deposits.

Q. Will the change impact the safety and soundness of credit unions and impact the National Credit Union Share Insurance Fund (NCUSIF) (which is the deposit insurance fund for all federally insured credit unions)?

A. Safety and soundness is a regulatory issue, and according to the Department of Banking and Finance, permitting credit unions should not impact the safety and soundness of those institutions under the assumption that asset deployment (loans/securities) is handled in satisfactory manner. Approved depository institutions must meet certain criteria established by the State Treasurer's Office that confirm satisfactory operations. The credit unions echo these opinions.

The possibility for future concern exists if only a limited number of credit unions participates in the program. It is unlikely that the bankers and thrift industry would acquiesce to assume the credit union liability in case of a failure. Therefore, there would likely be a separate pool guarantee for the credit unions and the exposure could be substantial if there was limited participation in the event the pool guarantee was exercised due to the failure of a QPD.

Q. Will the change negatively impact other depository institutions such as banks and savings associations?

A. The addition of the credit union industry to the public deposit program will likely increase the number of institutions bidding in the process, therefore increasing the competition for public funds. This could impact all institutions in the program in the form of minor rate increases due to the competition factor. The credit unions believe that some institutions may lose some deposits, but the impact will be minimal.

Q. Will the change benefit the State of Florida, local governments, and the citizens/credit union membership of the State of Florida?

A. The DBF and the credit unions believe that inclusion in the program would likely benefit the State of Florida as mentioned above with the potential increase in rates for public funds. It may also provide local governments a broader spectrum of choices in the types of institutions (banks/savings & loans and credit unions) with which they choose to conduct business. As an example, a local school board may choose an educational credit union for depository services over that of banks or thrifts due to the educational or member relationships.

Benefits to the citizens of the State of Florida would be in the form of increased revenues from public deposits driven by rate increases (increased competition) as mentioned above.

The credit union members could benefit by the additional funding provided by the public deposits in the form of loans and additional services.

Q. Is there sufficient credit union industry support or need to justify amending Chapter 280, F.S.?

A. According to the DBF, departmental staff attended a Florida Credit Union League Governmental Affairs Committee Meeting in November 2000. Only a limited number of attendees appeared to have an interest in public deposits. According to an internal survey created by the Florida Credit Union League and sent out to approximately 250 credit union members, 71 returned the survey and 43 expressed definite interest in participation in the program.

Q. Will the change improve competitive equality with federally chartered credit unions?

A. Neither federal nor state-chartered credit unions within the State of Florida can participate in the existing program due to the pool restrictions by the NCUA. Therefore, no competitive disadvantage exists within the State of Florida. However, other states do allow federal and state credit union participation in public deposit programs that do not have pool guarantee requirements.

Options

The impediments that kept the credit unions from participating in the Florida QPD program in 1996 still exist today. First and foremost, it is illegal for credit unions to participate in Florida's QPD Program, as it exists today. In addition, the credit unions have had a few years to formulate responses to the Treasurer's questions about their participation in the program. It seems incumbent upon the credit unions to first cross this technical threshold should the federal regulator change its position and permit credit unions to cross collateralize public deposits.

1. Maintain the status quo until such time as: (1) the federal regulator for credit unions changes its position regarding guaranty pools; and, (2) the credit union representatives satisfy the technical concerns raised by the State Treasurer.

2. Amend Chapter 280, F.S., to permit credit unions to participate in the QPD program. This change will necessitate creating a separate "pool" for credit unions that participate in the program and requiring a comprehensive examination of Florida

Statutes to ensure that sections that reference the QPD program are structured in a way so as not to thwart the intent of the Act. If that were accomplished, however, there is no guarantee that the federal regulator would change its position prohibiting one credit union to act as a guarantor for another.

3. Replace the cross-collateralization system in favor of another program. No one in the past five years has suggested an alternative system that offers a comfortable level of protection for public funds and is also as cost effective as the current system, which operates with 13 full time employees. Utilizing one of the other two systems (statutory permission to implement depository collateralization on a voluntary basis, or a general statewide requirement for full collateralization as a condition for doing business with public entities) would likely result in substantially increased costs to the State as well as to the individual public units and the private sector due to increased FTE requirements for contracting, collateral substitutions, regulatory reporting requirements (public and private), and collateral pledging would not likely go under 100 percent.